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The UK economy

The world economy continues to grow at a relatively strong rate with the US, Japan and some non-OECD countries being the principal areas driving growth. China and India in particular have experienced very fast growth and are forecast to continue at a similar pace over the next two years. Although the Euro Area has been growing at below trend there are now strong signs of a broad based recovery

that appears to be robust in nature and therefore growth is expected to return to trend in both 2006 and 2007. Global inflationary pressures remain relatively muted despite significant increases in the oil price but this reflects a decreased dependency on oil in the developed economies.

In the UK real GDP growth was 0.6 per cent in the first quarter of 2006, just as it was in fourth quarter of 2005. Growth for 2005 was 1.8 per cent and for the four quarters up to 2006Q1 growth was 2.2 per cent. As before services continue to drive the UK economy particularly financial services although there is much more broad based growth than previously seen.

Table 1: Independent forecasts of the UK economy

	2006	2007	2008
Real GDP growth (%)	2.3	2.5	2.6
Inflation rate (CPI %)	2.0	1.9	1.9
Inflation rate (RPI %)	2.5	2.4	2.3
Inflation rate (RPIX %)	2.3	2.2	2.3
Claimant count, (million)	0.98	1.02	0.99
Employment growth (%)	0.4	0.5	0.4
Average Earnings (%)	4.0	4.3	4.5
ERI (1990=100)	99.3	97.9	99.5
Current account (£ billion)	-31.8	-32.9	-35.0
(per cent of GDP)	-2.5	-2.5	-2.3
PSNB (£ billion)	38.1	37.3	34.4
(per cent of GDP)	3.0	2.8	2.5

Source: National Statistics, *National Institute Economic Review*, **196**, April 2006 and "Forecasts for the UK economy", HM Treasury, 228, June 2006 and 227, May 2006. Note: PSNB is given for financial years, e.g. 2005 is 2005/06

Outlook

The consensus forecasts for the main UK economic indicators are taken from a monthly survey by HM Treasury of City and other independent forecasters and are presented in Table 1. Real GDP growth was 0.6 per cent in 2006Q1 or 2.2 over the year. The forecast for UK GDP growth is 2.3 per cent in 2006 and 2.5 per cent in 2007. Investment and government spending are forecast to be important drivers of UK growth while there may have been a shift away from consumption towards investment and trade.

Inflationary pressures are steady but relatively subdued e.g. average earnings are well within expected bounds and there appears to be no significant pass through effects from high oil prices. The labour market is expected to

perform strongly. The current account is forecast to improve in the medium-run (to -2.3 per cent of GDP) a slight deterioration from our last forecast. The PSNB is forecast to rise to £38.1 billion in 2006-07. As a percentage of GDP this is 3.0 per cent.

Output growth and components of demand

UK GDP (chained volume measure) grew by 0.6 per cent in 2006Q1 which was the same as growth in 2005Q4. Growth was 1.8 per cent for 2005 and for the four quarters up to 2006Q1 growth was 2.2 per cent. GVA at basic prices grew by exactly the same as GDP (in the latest quarter and for over the year). The service sector remains the principal driver of UK GDP growth (the percentage contribution to GDP in 2006Q1 was 0.4 percentage points) although significant contributions were made in virtually all sectors. Only in distribution, retail and wholesale was quarterly growth below 0.5 per cent although on an annual basis

mining and quarrying, manufacturing and production made negative contributions.

Consumption growth in 2006Q1 was poor at only 0.2 per cent compared to 0.7 per cent in 2005Q4. On an annual basis consumption has grown by 1.7 per cent. Growth in government spending was 0.6 per cent (compared to 1.2 per cent last quarter) taking annual growth to 4.6 per cent. Investment grew by 1.5 per cent in the last quarter (compared to a contraction of 0.5 per cent last quarter) or by 3.7 per cent over the year. Export growth has strengthened significantly from 2.2 per cent in 2005Q4 to 4.7 per cent in 2006Q1 giving growth of 11.9 per cent over the last four quarters. Import growth in 2006Q1 has however, accelerated more quickly from 1.0 per cent in 2005Q4 to 5.5 per cent in the latest quarter. Thus imports over the year have grown by 12.0 per cent. This has meant that the deficit in net exports widened from £10.8 billion in 2005Q4 to £12.0 billion in 2006Q1. The contribution of net trade to growth over 2005 was broadly neutral but the Bank of England expects a slight improvement in 2006 although it may remain a marginal situation.

While the pattern of expenditure is uneven the most significant factor is the slowing of consumption growth from 0.7 per cent to 0.2 per cent. This leaves average consumption growth around 0.5 per cent. Given the lack of any sizeable revision by ONS to the data it may be that the change is not a temporary one due to discounting or a change in a seasonal pattern but could be evidence of a significant change towards investment and trade expenditure.

Growth in services was 0.6 per cent in 2006Q1 or 3.0 per cent on an annual basis. Within financial and business services growth was strongest at 0.8 per cent over the quarter and 3.9 per cent over the year. Growth in retail, wholesale and distribution was disappointing at only 0.4 per cent in 2006Q1. Growth in financial intermediation was 2.7 per cent for the first quarter (5.4 per cent on an annual basis). Hotels and restaurants grew by 1.7 per cent in 2006Q1. On an annual basis the strongest growth came in financial intermediation (5.4 per cent); real estate and business services (5.2 per cent); other services (4.2 per cent) and in post and telecommunications services (3.6 per cent).

Production increased by 0.8 per cent in 2006Q1 but declined by 0.9 per cent over the year. Manufacturing grew by 0.7 per cent as did mining and quarrying while electricity, gas and water supply increased by 1.8 per cent. It would appear therefore that most sectors of the economy are growing relatively strongly and that the slowdown towards the end of 2005 has passed. Output in the construction industry increased by 0.7 per cent in the first quarter and advanced by 1.0 per cent on an annual basis. The UK current account widened to -£19.2 billion in the fourth quarter of 2005 compared to -£10.1 billion in the same quarter of 2004. The UK deficit on trade in goods and

services fell from -£5.2 billion in February 2006 to £4.0 billion in March and was unchanged in April. For the three months ended April 2006 the deficit was £13.2 billion, unchanged from the previous three months. The balance on trade in services remains positive and close to trend.

A current budget surplus of £3.0 billion was recorded in April 2006 compared to £1.7 billion in April 2005. Net debt was estimated to be £418.4 in April 2005 (34.3 per cent of GDP) and rose to £457.1 billion in April 2006 or (36.3 per cent of GDP). The public sector had net borrowing of -£1.4 billion in April 2006 compared to -0.9 billion in April 2005. The PSNB requirement for 2005/06 is £38.9 billion compared to £39.7 billion in 2004/05.

Prices

CPI inflation was 2.2 per cent for the 12 months to May 2006 compared to 1.9 per cent in April 2005. Growth of the RPI in the same period was 3.0 per cent compared to 2.9 per cent 12 months ago. RPIX grew by 2.9 per cent in May 2006 while in May 2005 the 12 month growth rate was only 2.1 per cent. Housing, water, fuel and electricity were the components that increased the index most significantly. Other items contributing to a rise in inflation included food and non-alcoholic beverages and clothing and footwear. Notably the cost of air travel fell slightly although it increased considerably a year ago. The output price for manufactured products increased by 3.0 per cent to May 2006. This compares to 2.5 per cent to April and 2.7 per cent in May 2005. Average earnings growth is non-inflationary and interest rates were kept on hold at 4.5 per cent but it is increasingly likely that the mpc will vote for another increase of 25 basis points in 2006. The outlook for inflation and interest rates is presented in Table 1.

The RBS/CIPS PMI survey for the UK showed that manufacturing strengthened with the index at 53.2, slightly down on the 54.0 recorded in April. In the service sector the result was similar; the May index was 57.2 compared to 57.9 in April. Average earnings grew by 3.8 per cent (excluding bonuses) or by 4.3 per cent (including bonuses) in the private sector in March 2006. In the manufacturing sector growth was 4.6 per cent and 4.8 per cent respectively.

The labour market

UK employment stood at 28,896,000 in January-March 2006, an increase of 127,000, giving an employment rate of 74.7 per cent up from 74.5 per cent on the previous period. ILO Unemployment was 1,586,000 or 5.2 per cent for January-March 2006 compared to 1,541,000 (5.1 per cent) in the previous period (October to December 2005). January-March 2005 recorded employment of 28,679,000 (74.9 per cent) and ILO unemployment of 1,409,000 (4.8 per cent). Claimant count unemployment for April 2006 was 945,500 or 3.0 per cent compared to 937,800 (3.0 per cent) in March 2006 and 839,200 (2.7 per cent) in April 2005.

Unemployment on this measure has increased by 106,300 or by 12.7 per cent over the year. The unemployment rate has only increased by 0.3 percentage points. There were 30,482,000 (78.8 per cent) economically active people in January-March 2006 compared to 30,087,000 (78.6 per cent) in January-March 2005. The change over the year is 395,000 (0.2 percentage points) respectively. The numbers of economically active people have increased by 1.3 per cent on an annual basis. There was a small change (-79,000) in those who were economically inactive (17,568,000) and the rate fell slightly to 21.2 per cent.

Self employment increased by 48,000 over the latest quarter to 3,748,000 and this was a change of 119,000 over the year. Full-time employment increased to 21,577,000 in January-March 2006, up 85,000 over the quarter and by 158,000 over the year. Part-time work increased from 7,297,000 to 7,339,000, a rise of 43,000 over the period and up 60,000 over the year. The number of people with second jobs declined slightly; by 4,000 over the quarter but by 31,000 on an annual basis. Employment increased in virtually all sectors of industry with the exception being retail, wholesale and distribution. The largest gains were in the financial and public sectors. Employment growth was much less marked in energy and water; manufacturing and construction. There were 568,700 vacancies in the three months to April 2006 which is down 4,100 from the previous three months and by 32,000 on an annual basis. This gives a ratio of 2.3 vacancies per 100 jobs which is unchanged from the previous quarter. Redundancies are up by 1,000 from the previous three months and by 10,000 from the previous year. Manufacturing productivity increased by 2.9 per cent in January-March 2006 while unit wage costs rose by 1.9 per cent, compared with the same period earlier.

The UK labour market remains flexible and competitive with the second highest employment rate in Europe and a very low rate of unemployment. Caution is needed here however, as unemployment is clearly increasing and at a rate greater than the economic activity rate – we are not creating enough jobs for those who wish to have a job. One of the sources that impact significantly on this is the number of immigrants, particularly from Eastern Europe. This has been a boost to the economy and has meant the pressure on average earnings has been lower thus helping to mitigate the effects on inflation from higher wage costs. Furthermore the number of long-term unemployed is rising and is now approaching 40 per cent of the total number unemployed. The second half of 2006 and 2007 are forecast to have an improved labour market.

The outlook for the UK economy remains promising despite a slowing of growth in 2005. The forecast for growth in the medium-term is 2.5 per cent. Inflationary pressures are subdued and it is still unlikely that there will be any shocks in the UK economy especially arising out of higher oil prices. The main risks to the economy are global imbalances, a significant correction either to the US or the UK housing market or oil prices feeding into the wage bargains through second round effects. On balance however there is a greater sense of optimism and the balance of risks have moved towards the positive. There could be just a temporary blip in consumption spending resulting in higher than forecast consumption, looser monetary policy could expand output slightly above expectations and exports could get a greater boost than expected due to the sustained recovery in the Euro Area.

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